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Testimony Before
The Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives

On the Basel II Capital Accord

The Bond Market Association is grateful for the opportunity to testify on the Basel Committee on Banking Supervision's proposed new capital accords, or Basel II. The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. Association member firms account for in excess of 95 percent of all primary issuance and secondary market activity in the U.S. debt capital markets. Through our affiliate American and European Securitization Forums, we represent a majority of the participants in the growing securitization markets in the United States and Europe. The following comments focus on only those issues related to Basel II that are most important to our membership.

I. TBMA Supports the Goals of Basel II

The Association supports the Basel Committee's overall goal of rationalizing the current risk-based capital regime, and aligning regulatory capital requirements more closely with actual credit risk. This goal is critically important to the global financial market, in which capital flows are increasingly mobile and interdependent. Also, we are grateful to the Federal Reserve Board and other U.S. bank regulatory agencies for working with us to address the issues presented by the proposed capital accord revisions that affect the domestic bond market. While some of our concerns expressed previously were addressed in the Basel Committee's third consultative paper (CP3) on Basel II, critical issues still remain.

The Basel Committee has an important role in promoting a prudential but efficient allocation of capital throughout the banking system. An updated regulatory capital regime can produce significant benefits, including the promotion of fair global competition, the creation of incentives for better internal risk management, and an economically efficient allocation of capital to its most productive uses.

Although we support the direction and goals embodied in Basel II, the revised Accord should not be viewed as the last word on regulatory capital. In attempting to promulgate a universal rules-based system that applies the same basic capital requirements to all regulated financial institutions, Basel II—like its predecessor—is overly rigid and prescriptive in certain critical respects. However, no such "one-size-fits-all" regulatory capital regime can fully accommodate the unique needs of these diverse institutions, or flexibly respond to rapid changes in the financial markets in which they operate, without suffering from this basic limitation. To overcome this deficiency, the global financial community will need to move toward a broader reliance on internal risk models, with supervisory review and approval, to determine appropriate regulatory capital levels, and we encourage financial market regulators to continue moving in this direction.

In the meantime, our comments focus on aspects of the proposed Accord that we believe will, at least in the short term, facilitate the goal of aligning regulatory capital requirements more closely with actual credit risk.

The Association has principally focused on two areas of the proposed Basel Accord that significantly affect the bond markets—securitizations and collateralized transactions, including securities repurchase (repo) and securities lending arrangements. By creating more risk-sensitive capital standards in these areas, Basel II can ensure these transactions continue to serve as useful funding, liquidity and risk management tools.

Securitizations allow banks and other entities to obtain efficient funding and to remove certain risks from their balance sheet so they can be borne by other parties who desire such an exposure. Repo and securities lending transactions also aid institutions in managing risk by allowing them to readily obtain securities in order to meet delivery obligations and to hedge exposures arising from separate transactions. Setting regulatory capital charges too high for these increasingly important and widely used arrangements threatens to distort economic decision making on the part of a financial institution. This has the potential of eroding the significant benefits that consumers and businesses alike realize from securitization and collateralized transactions.

II. Background on the Securitization and the Repo and Securities Lending Markets

II. a. Market Size

The past several years have seen phenomenal global growth of the securitization market. Since 1995, the U.S., European and Asian markets combined have grown from $497 billion to $2.9 trillion The U.S. market by itself has accounted for about 95 percent of that volume.

The repo market has also shown steady growth over the same period. Approximately $1.7 trillion in repo and securities lending transactions were outstanding on average in 1996 and today an average $3.7 trillion are outstanding. Hundreds of billions of dollars in repo transactions are conducted daily to fund the positions of bond market participants and allow the Federal Reserve Board to conduct open market operations.

II. b. Benefits of Securitization and Securities Lending and Repo Agreements

Securitization offers numerous benefits to consumers, investors, regulators, corporations and financial institutions.

Securitization has developed as a large market that provides an efficient funding mechanism for originators of receivables, loans, bonds, mortgages and other financial assets. Securitization performs a crucial role for the entire U.S. economy by providing liquidity to nearly all major sectors including the residential and commercial real estate industry, the automobile industry, the consumer credit industry, the leasing industry, and the bank commercial lending and corporate credit markets. In addition, securitization has provided a means for banks to effectively disperse the risk of various positions they hold throughout the broader financial market.

Securitization provides low-cost financing for banks and other companies, lowers borrowing costs for consumers and home buyers, adds liquidity to banks' balance sheets, provides for efficient bank balance sheet and capital management, and draws non-traditional sources of capital to the consumer and corporate lending markets. The efficiencies introduced by securitization are passed on to consumers and businesses in the form of more widely available credit, lower interest rates and lower prices.

Securities Lending and Repurchase Transactions

Securities lending and repo transactions are integral to maintaining liquidity in the capital markets. They are a secure and flexible method of obtaining funding and securities for market participants. For example, a market participant may purchase securities which are then sold in a repo transaction, with an agreement to repurchase such securities sometime in the future. The repo seller can use the proceeds of this transaction to fund their initial purchase. The repo buyer is able to invest funds for short periods in a safe and liquid product. By providing a ready source of funding, repos and securities lending transactions are critical to maintaining liquidity in the bond markets. In the Treasury markets in particular, this liquidity ensures that the Treasury's borrowing costs are kept low. In short, America's capital markets operate as efficiently as they do because wholesale market participants can use repos and securities lending transaction to finance and hedge positions. The liquidity and efficiency provided by the repo market lowers financing costs for the federal government, home buyers, corporations and consumers.

III. Basel II's Impact on Securitization and the Repo and Securities Lending Market

The Association applauds the goal of the Basel Accord to allow financial institutions the ability to more closely tailor risk-based capital requirements to the actual amount of risk present in financial transactions. The proposed Accord, however, does not currently meet this goal because under the proposal, institutions would be required to maintain a higher level of capital than is warranted by the practical risk of their positions. We have summarized below some of our principal concerns in connection with the proposed capital treatment of securitization exposures and repo and securities lending transactions. The Association is continuing to develop additional quantitative and analytical arguments to support these points, which will be submitted prior to the July 31 comment deadline in response to the CP3. The Association will share our comments with committee members at that time.

III. a. Securitization

The Association is troubled by the treatment in Basel II of certain securitization products and positions. We are especially concerned that if Basel II is not amended, the onerous capital charges imposed on banks will discourage them from engaging in securitization transactions. As a result, the benefits conveyed by a robust and efficient securitization market would be diminished or lost.

Securitization Risk Weights Are Too High

The floor capital charge is too high for many types of securitization positions, given their actual risk profile. Sub-investment grade positions in particular attract too high a capital charge under the proposals, given the actual credit risk they present. Many of the key assumptions underlying securitization formulas and risk weights are too conservative, and lack a proper theoretical or empirical foundation.

By setting the floor requirements at a higher level than the actual risk of a position, Basel II reduces incentives for banks to participate in securitizations. This would lower incentives to conduct transactions that actually lessen a bank's risk exposure and that allow banks effectively to disseminate the risk of a particular transaction throughout the marketplace.

Conservative Rules Result in Inordinately High Charges

In establishing rules governing the manner in which regulatory capital computations are to be made, Basel II defaults to the conservative alternative so often that—cumulatively—these rules result in an inappropriately high capital charge for securitizations. For example, given the general ability under Basel II to rely upon qualified external ratings to determine regulatory capital requirements, we believe that originators of securitized assets should be able to use such ratings to determine risk weights, even if this produces a lower capital charge than if the assets had not been securitized. Originators do not have this ability under the proposal as drafted. There are numerous other examples of excessively conservative rules that—in the aggregate—produce unduly high capital charges for securitizations.

Synthetic Securitizations Should Not Be Discriminated Against

Higher capital charges should not be levied against synthetic securitizations, in comparison to traditional asset securitizations. (Synthetic securitizations involve the bundling and securitization of credit exposures, rather than the underlying financial assets.) Synthetic securitizations are increasingly used by financial institutions to manage their balance sheets, and provide additional options and flexibility for risk management. Since the risk profile of a synthetic asset is the same as for a cash asset, the risk based capital treatment should be equivalent. However, this would not be the outcome under the proposals as currently drafted and, in several respects, synthetic securitization positions attract inordinately high capital charges.

Limited Credit Risk Inherent in Liquidity Facilities Should be Recognized

In a number of important respects the Basel II proposals would require financial institutions to hold disproportionately high levels of capital against liquidity facilities they provide in connection with securitizations. Such liquidity facilities are extended by financial institutions to a variety of securitization issuance vehicles, including but not limited to asset-backed commercial paper conduits. Through the securitization market, these conduits provide competitive short-term financing for a wide range of asset originators. The performance history of liquidity facilities in this context demonstrates that the likelihood of draws are extremely low, and the incidence of credit losses negligible.

We believe that internal modeling is the most appropriate method for determining regulatory capital for liquidity facilities. The key operational requirement for liquidity facilities is that there be an asset quality test that adjusts dynamically to preclude funding of defaulted assets. Such a dynamic test is one that is built into liquidity facilities that have been in the market for years, and that has led to historical performance data showing the relatively low risk of draws and of losses on such draws.

Under Basel II, if a liquidity position is not rated, we believe that a bank should be able to look through to the risk weight assigned to the underlying transaction that the liquidity supports if that underlying transaction has been externally rated. Given that the underlying transaction reflects the ultimate risk of a liquidity position, we see no reason not to permit the reliance on the rating of that transaction if a liquidity position itself is not rated.

III. b. Securities Lending and Repurchase Transactions

The Association is concerned that Basel II, as proposed, falls short with regard to recognizing modern risk-management techniques as they relate to secured transactions such as securities lending and repurchase transactions. By failing to account for methods widely used to mitigate risk exposure, capital charges for banks would not reflect true balance sheet risk. The undue capital charges would ultimately result in less efficient and more costly markets.

Encourage the Use of Cross-Product Netting as a Risk Management Techniques

The Association believes that the manner in which risk based capital requirements for repo and securities lending transactions are calculated should be revisited along with the treatment of similar collateralized transactions. The Association strongly believes that transactions which present similar risks—and mitigate against similar risks—as repo and securities lending transactions should be treated in the same way for risk-based capital purposes. Many financial institutions currently manage risks for all collateralized transactions in a uniform manner.

After conforming the manner in which risk is calculated for repo and securities lending transactions and other collateralized transactions, the Basel Accord should take the next logical step and allow for recognition of the netting of exposures across such transactions. Currently the Basel Accord contemplates netting only between repo and securities lending transactions. It is widely recognized that netting exposures across different transactions helps financial institutions reduce their exposure to the risks such transactions present. Providing incentives in the Basel Accord through broader recognition of cross-product netting will provide added incentives for financial institutions to implement this risk-reducing practice.

Encourage the Use of Internal Risk Models

It is the Association's view that allowing financial institutions to utilize internal risk models—as Basel II would—to determine counterparty risk for collateralized transactions is a step in the right direction. Basel II should not, however, dictate rigid rules as to what models financial institutions must utilize in determining risk. The Accord should allow financial institutions to utilize their own risk models subject to the review and approval of national supervisors under Pillar 2 of the Basel Accord. Otherwise, financial institutions would likely devote resources to creating a model that may not accurately capture the risks present in collateralized transactions. In addition, the Association believes the Accord should not set out a rigid backtesting regime for such models. (In this case, backtesting refers to evaluating the performance of a model based on historical data.) In any event, the backtesting regime currently set out in the Basel Accord risks dissuading financial institutions from improving upon their existing risk management practices through the use of internal risk models by risking the imposition of significantly increased capital charges. As currently contemplated, should the results of the backtesting regime generate a number of mismatches or "exceptions" between estimated and actual data, an institution's risk-based capital charge would be significantly increased. Such backtesting regime—and its potentially punitive results—do not have any commercially reasonable basis in relation to the repo and securities lending markets.

IV. Conclusion

The Association supports the overall goal of the Basel Committee to align capital requirements for financial institutions more closely to actual credit risk. While the revised Accord has the potential to move regulatory capital requirements in the right direction, the Association continues to have fundamental concerns with the proposal that must be addressed to uphold the Basel Committee's stated goals without causing economic distortions in the securitization, repo and securities lending markets.

The Association looks forward to continuing its dialogue with the Federal Reserve Board and other U.S. regulators on the issues we have addressed above. We plan to offer formal comments on the third consultative paper this summer, and when the Board issues its advanced notice of proposed rulemaking describing the U.S. implementation of Basel II, the Association will provide further input.